M&G (Lux) Dynamic Allocation Fund

Fund Manager Q&A

With Juan Nevado and Ana Cuddeford

FOR INVESTMENT PROFESSIONALS ONLY

September 2018

Juan Nevado, manager of the M&G (Lux) Dynamic Allocation Fund, speaks with M&G Multi Asset team investment director Ana Cuddeford to share his views on a challenging market environment in 2018 and opportunities he sees in the coming period.

Ana Cuddeford (AC): This year has surprised investors in many ways, with the S&P 500 appearing almost unstoppable, while many other assets have struggled. What do you think is driving this?

Please remember that the value of investments will fluctuate, which will cause fund prices to fall as well as rise, and you may not get back the original amount you invested.

Juan Nevado (JN): Despite negative investor sentiment in 2018, we believe there have actually been few material changes to what we consider fundamental drivers of asset returns from a medium- to long-term perspective. This includes global economic growth and company earnings, which have continued to hold up.

Our market assessment is therefore that this year's volatility may at least be partially explained by the presence of short-term, irrational investor behaviour, which has been triggered by fears around trade wars, occasional data surprises and political events in Europe. This has been underpinned by uncertainty created by rising US interest rates and subsequently asset valuations relative to US Treasuries.

We believe the extent of recent asset price movements in non-US equities and emerging market (EM) assets are therefore largely an overreaction and represent the type of opportunities our 'Episode' investment philosophy is designed to exploit.

AC: How have you positioned the fund to reflect this view?

JN: The portfolio is positioned to take advantage of what we believe is a significant equity risk premium compared to other asset classes, particularly developed market (DM) government bonds, as well as the positive overall outlook for growth.

Within equities, our strong preference has been for non-US markets, where average 12-month forward earnings yields are significantly higher than the 5.8% offered by the US S&P 500 (source: Bloomberg, 28 August 2018). In fixed income, we hold short positions in DM government bonds, notably Japanese JGBs, German bunds and UK gilts. In EMs, we hold a diverse range of positions across asset classes, including both long and short exposure to selected currencies.

AC: The fund is known for its dynamic approach. How have you been able to utilise this in 2018?

JN: Throughout the year, we have been highly active in scaling positions in response to changing asset valuations. Most notably, we reduced net equity allocation from 42% to 38% in January, as we felt the global stockmarket rally had left markets vulnerable to a correction. Similarly, we cut net credit from 4.5% to 0.5% by removing high-yield exposure as spreads had become unattractive. Though we could not predict its timing, the market downturn happened in February as US inflation fears grew. Following subsequent bouts of stockmarket volatility, we built up equity exposure to 47% by the end of August to capitalise on what we believe are highly attractive valuations in European and Asian markets.

Despite the extent of market volatility, we made very few changes to the portfolio in August itself. This is because our outlook on the fundamentals is largely unchanged, and we believe positions affected have significant scope to recover.

AC: It has been a challenging extended period for non-US equities and EM assets generally. How has this affected fund performance?

Figure 1. Fund performance* – 5 calendar years and since launch (%), as at 31 August 2018

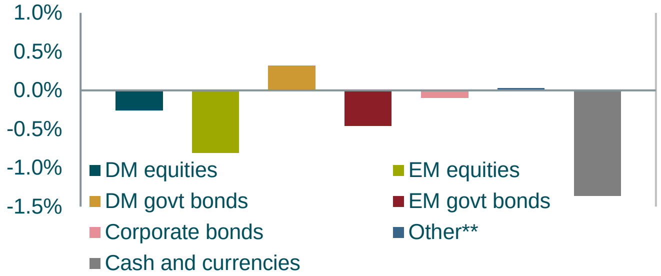
Period	YTD	2017	2016	2015	2014	2013	Since launch pa
Fund (EUR A)	-4.3	8.3	8.8	2.0	9.8	6.5	5.5
Sector	-1.5	6.1	2.1	0.9	6.0	7.5	4.1

Source: Morningstar Inc., Pan European database as at 31 August 2018, Euro Class A shares, income reinvested, price-to-price basis. *Past performance prior to 16 January 2018 is that of the M&G Dynamic Allocation Fund (a UK-authorised OEIC) which merged into this fund on 16 March 2018. Tax rates and charges may differ. "Since launch" refers to the launch date of the M&G Dynamic Allocation Fund, which was 3 December 2009. Sector is Morningstar EUR Flexible Allocation - Global Sector.

Past performance is not a guide to future performance.

JN: Year-to-date (YTD), the fund has delivered total net returns of -4.3% for euro A class accumulation shares. Within equities, our long positions in European, Japanese and selected EM stockmarkets have delivered negative returns overall. We also hold a short position in the S&P 500, which is part of a relative value trade versus US sectors we feel are undervalued, namely banking, biotech and oil. This has

Figure 2. Performance contributions, 2018 YTD



Source: Bloomberg, 31 August 2018. Investment returns (gross of fees) in absolute terms, calculated in euros at end-of-day pricing. **Mainly real estate-related securities and convertibles. Data is produced internally, unaudited and may differ from that shown in Monthly Fund Reviews.

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detracted from performance in 2018. Some of our sector positions have partially offset other equity losses.

In fixed income, our short positions in German bunds have delivered negative YTD returns. However, our positions on the US and UK yield curves have contributed positively.

We hold a diverse basket of EM currencies, which has delivered negative returns overall. However, this has mostly been driven by the sharp fall in Turkish lira, which the fund held a 3% position in at the start of August. Short positions in selected Asian currencies (both Japan and EM) have provided some protection during periods of market volatility.

AC: 'Episodic' investing sometimes involves going against our emotions. How does 2018 compare to previous years?

JN: We are always mindful that we are managing other people's money. This is never more pertinent than when performance is challenged. However, our experience over the past 20 years has taught us to continue applying our investment philosophy even if this is emotionally challenging.

Although 2018 performance has been negative, it is not unusual for the fund to intermittently experience drawdowns, given our aim is to capitalise on market volatility and mispricing opportunities.

We recognise that portfolio volatility and drawdowns were relatively high in August 2018. However, they were not unprecedented in this wider context (see Figure 3).

AC: The fund has direct exposure to Turkish assets, which have dominated recent headlines. What's your view on the current situation?

JN: We are watching the situation in Turkey closely to assess potential changes in fundamentals. At present, we believe Turkish assets have upside potential, given the enormous extent of August's sell-off. As such, we have retained our small positions in Turkish equities, bonds and

Figure 3. Historical monthly fund returns*

Monthly returns (%)	J	F	M	A	M	J	J	A	S	O	N	D
2010	0.7	1.1	4.3	0.2	-1.4	-0.1	-1.0	0.2	0.1	-0.5	2.6	1.4
2011	-2.0	1.6	-1.0	0.8	1.0	-2.0	1.3	-5.0	-2.1	5.7	-0.7	2.3
2012	3.8	2.2	-0.5	0.3	-3.0	0.9	2.9	0.0	1.0	-0.2	1.2	0.7
2013	1.1	1.7	1.8	1.2	0.4	-3.9	1.9	-0.8	2.3	1.9	-0.1	-0.8
2014	-1.6	2.2	1.0	0.7	2.8	-0.2	1.1	1.0	0.1	0.6	2.0	-0.2
2015	4.5	2.6	1.2	0.0	1.2	-2.2	0.3	-4.1	-3.1	4.7	0.9	-3.3
2016	-4.9	-0.2	4.2	2.9	0.1	-3.0	2.2	1.9	-1.0	3.1	0.6	2.9
2017	1.1	0.5	1.6	0.5	0.5	1.4	0.4	-0.7	2.2	1.0	-0.4	0.1
2018	2.4	-1.6	-2.3	2.0	-1.9	-1.0	1.6	**-3.4**				

Source: Morningstar Inc., Pan European database as at 31 August 2018, Euro Class A shares, income reinvested, price-to-price basis. *Past performance prior to 16 January 2018 is that of the M&G Dynamic Allocation Fund (a UK-authorised OEIC) which merged into this fund on 16 March 2018. Tax rates and charges may differ.

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lira. However, we have not increased our direct exposure, given other assets in the portfolio have also been affected by contagion. We prefer instead to diversify our exposure to the situation via other EM assets and European banks.

AC: Given our discussion today, where do you see potential risks and opportunities from here?

JN: We believe US interest rates will continue to be a key focus for markets, with yields on US Treasuries having implications for the valuations of all other major assets. While other developed economies are further behind the US in their economic recoveries, we believe the gradual path towards monetary policy tightening will continue to pressure yields on other perceived 'safe-haven' assets.

In the current political environment, there is always scope for the outlook to quickly turn positive as well as negative. Many asset valuations today appear to have priced in widespread investor negativity, providing scope for potential surprises to the upside.

Our investment strategy has enabled us to capitalise on numerous periods of volatility over the past 20 years. Therefore, while this volatility may at times feel uncomfortable for investors, we believe our portfolio is well-positioned from a medium-term valuation perspective.

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The fund allows for the extensive use of derivatives.

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